Clients&FriendsMemo

Proposals for a European Union Financial Transactions Tax

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The proposals made by the EU Commission on 28 September 2011 regarding an EU directive on a common system of financial transaction taxation in the 27 Member States of the EU have been debated widely in the six weeks since they were presented. The presentation of the proposed Directive (the "**Directive**"), together with proposals to amend Directive 2008/7/EC concerning indirect taxes on the raising of capital, represent the latest stage in a series of announcements by EU authorities directed towards ensuring that the European financial sector should "contribute more fairly"[3] towards the costs of addressing and rectifying the current European financial crisis. A series of conclusions from the European Council[4], communications addressed to the European Parliament[5] and EU Commission staff working papers[6] and consultations throughout 2010 and 2011 have created a platform upon which the relative merits of various options for taxing the financial sector have been analysed. These developments have taken place in tandem with both Member State initiatives (such as the UK bank levy introduced in Finance Act 2011[7]) and international discussions involving the International Monetary Fund[8] and the G-20 group of countries[9].

With the depth and nature of the European financial crisis continuing to evolve and the costs of stabilising and recapitalising the European financial sector showing no signs of abating, the

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3 EU Commission Explanatory Memorandum on the Directive (the "**Explanatory Memorandum**"), paragraph 1.1, page 2.

4 Council of the European Union, 17 June 2010.

5 Communications of the EU Commission to the European Parliament, 7 October 2010.

6 EU Commission staff working document entitled "*Innovative Financing at a Global Level*", 1 April 2010; EU Commission staff working document entitled "*Taxation of the Financial Sector*", 7 October 2010; EU Commission consultation on options for taxation of the financial sector, 22 February 2011.

7 Section 73 and Schedule 19, Finance Act 2011.

8 IMF working Paper "*Taxing Financial Transactions: An assessment of administrative feasibility*", WP/11/85, August 2011.

9 Meeting of G-20 Ministers, April 2010 "*A Fair and Substantial Contribution by the Financial Sector*".

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Directive comes at a profoundly sensitive political and economic time. This memorandum considers both the mechanics of the proposed financial transaction tax (the "**FTT**") and looks at some of the challenges which the EU Commission, Member State governments and financial institutions will face in attempting to create a workable tax which achieves the aims of its proponents. The analysis in this memorandum is based on the Directive, and supporting documents, published on 28 September 2011.

Objectives

The objectives of the FTT have been stated by the EU Commission as being:

- to raise revenue and obtain an adequate contribution from the financial sector to compensate for the costs of the financial crisis, thereby ensuring a "level playing field with other sectors from a tax perspective";
- to limit undesirable market behaviour and stabilise markets; and
- to ensure the functioning of the internal market of the EU and prevent internal market fragmentation through disparate unilateral Member State initiatives.[10]

These objectives are, in turn, devolved from the reasoning behind the FTT that, among other things, the financial sector "should bear its fair share of the costs of the financial crisis"[11] and that the financial crisis was attributable to, or exacerbated by systemic risks in the financial sector, not least of which was the proliferation of financial products and counterparty risk.

Scope of FTT

Tax base

The FTT is a tax applied to financial transactions where at least one of the parties is a financial institution and either that party or another party to the financial transaction is established in a Member State of the European Union (a "**Member State**"). The key terms "financial transaction" and "financial institution" are both defined in the Directive. It is not relevant whether the financial institution which is a party to the transaction is acting as a principal or an agent in that transaction[12].

The definition of "**financial institution**" includes a wide range of entities, including banks, credit institutions, insurance and reinsurance undertakings, pension funds, UCITS collective

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[10] Explanatory Memorandum, paragraph 1.1; Executive Summary of the Impact Assessment Report on "Instruments for the Taxation of the Financial Sector", dated 28 September 2011 (the "**Impact Assessment**"), paragraph 4.

[11] Impact Assessment, paragraph 3.1 page 2.

[12] Article 3.1(e) of the Directive makes reference to where a person acts "either for its own account or for the account of another person, or is acting in the name of a party to the transaction". The conjunction of these legislative expressions is likely to be a result of attempting to embrace both common law and civil law principles of agency (see "Agents as permanent establishments under the OECD Model Tax Convention", D.A. Ward and J.F. Avery-Jones; *British Tax Review* 1993 at 341).

investment funds and their investment managers, securitisation SPVs and other special purpose vehicles and certain leasing companies.[13] The breadth of the definition of financial institution may also encompass Treasury companies within corporate groups, which points towards a possible inconsistency between the financial sector-focused policy objectives underpinning FTT and the precise drafting of the Directive.[14] Central counterparties for clearing houses, securities depositories, the European Financial Stability Fund and (with an eye to the future, possibly) any "international financial institution established by two or more Member States which has the purpose to mobilise funding and provide financial assistance to the benefit of its members that are experiencing or threatened by severe financing problems" are not "financial institutions".[15]

Where a person carries on deposit taking, lending, providing guarantees, finance leasing or participates in financial instruments as a "significant activity in terms of volume or value of financial transactions", such a person would also be treated as a financial institution[16].

Financial transactions

The FTT taxes a "**financial transaction**". This is defined as being:

- the sale and purchase of a financial instrument before netting or settlement including repos and securities lending agreements;
- the transfer between group entities of the right to dispose of a financial instrument and any other operation effecting a transfer of risk associated with that instrument; and
- the "conclusion or modification" of derivatives agreements (the terms "**conclusion or modification**" are not further defined in the Directive and no further guidance is given in any of the supporting documentation produced by the EU Commission). The entry into a derivative, any change in its terms, any extension or close out of a derivative, whether cash or physically settled would appear to fall within these concepts and therefore fall within the scope of FTT. Certain types of derivatives, such as variance swaps, reflect daily price changes based on the closing price of the underlying product, so such swaps can arguably be said to be "modified" on a daily basis.

Any "subsequent cancellation or rectification" of a financial transaction has no effect on chargeability (except where an error can be proven), with no rebate of previously chargeable tax being available in these circumstances.[17]

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[13] Directive, Article 2.1(7).

[14] While the Impact Assessment notes that a policy objective is to submit "intra-group financing and shadow-banking activities" to FTT (Impact Assessment, paragraph 7.4) a distinction can be drawn between shadow-banking and a hedging strategy pursued by a corporate group through a single treasury company.

[15] Directive, Article 1.3.

[16] Directive, Article 2.1(7).

"**Financial instruments**" are themselves defined as being the instruments falling within Section C of Annex I of Directive 2004/39/EC (the Markets in Financial Instruments Directive). This definition encompasses a wide range of instruments covering shares, securities (including listed bonds), units or shares in collective investment undertakings, options, futures and other derivatives. Derivatives are included irrespective of whether they are physically or cash-settled and regardless of whether the underlying is itself a financial instrument[18]. Both repos and securities lending agreements are expressly defined as "financial instruments", as are "structured products", the latter being securities or other financial instruments offered by way of securitisation[19] or equivalent transactions involving the transfer of risk other than credit risk. The Explanatory Memorandum to the Directive makes it clear that the scope of FTT extends to regulated markets, multi-lateral trading facilities and also over-the-counter trading in financial instruments.

Importantly, a number of transactions are excluded from the scope of FTT. The EU Commission has announced that "all transactions in which private individuals or SMEs were involved would fall outside the scope of the tax"[20]. Elsewhere reference is made to "ring-fencing of the lending and borrowing activities of private households, enterprises or financial institutions and other day-to-day financial activities".[21] The precise scope of this exclusion is currently unclear. It appears that mortgage lending, consumer credit and consumer insurance transactions will fall outside the scope of FTT. However, subsequent trading of these instruments, for example, through securitisations, would fall within the scope of FTT.

Other absences from the list of financial instruments include loans, deposits, spot forex transactions, physical commodities and emissions credits. A number of these are surprising given the otherwise broad definition of "financial instruments".

Primary market transactions including the issuance, allotment and subscription of financial instruments are, however, excluded from the scope of FTT.[22] The reason given for the exclusion is "so as not to undermine the raising of capital by governments and companies"[23]. However, the issue and redemption of shares and units in collective investment undertakings and alternative investment funds fall within the scope of FTT. With derivative hedges entered by

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17 Directive, Article 4.2. It is submitted that classification will be required regarding the meaning of "rectification" in this context. It is difficult to construe "rectification" in anything other than a correction of an error, although the Directive appears to divorce the process of rectification from the occurrence of an error.

18 Accordingly, a derivative over land or over a commodity would be a "financial instrument" for the purposes of the FTT.

19 Within Article 4(36) of the Banking Consolidation Directive (2006/48/EC).

20 Europa Press Release: "Common Rules for a Financial Transaction Tax – Frequently Asked Questions" (28 September 2011), page 2.

21 Explanatory Memorandum, paragraph 2.2, page 4.

22 Directive, Article 1.4.

23 Explanatory Memorandum, paragraph 2.2, page 4. The justification is also advanced that the exclusion of primary market transactions is consistent with the policy of the EU Commission in Directive 2008/7/EC.

such funds being subject to FTT and being unable to claim corporate tax deductions for any FTT liability (assuming such funds are exempt from corporate taxes, as is often the case), the taxation of fund issuances, transfers and surrenders is likely to result in UCITS funds and Alternative Investment funds being severely affected by FTT.

Transactions with Member States central banking institutions and with the EU or EU institutions (such as the European Central Bank) are also excluded from the FTT. Curiously, transactions with non-Member States' central banks (such as the US Federal Reserve Bank of New York) are not excluded.[24]

Territoriality

For a financial transaction to be within the scope of FTT, two requirements are necessary: (i) at least one party to the transaction must be "established" in the Member States; and (ii) a financial institution "established" in a Member State must be a party to the transaction acting either for its own account or as an agent. A number of deeming provisions widen the ostensible scope of the second limb of the test. A financial institution is deemed to be "established" in a Member State if the financial institution has (amongst other factors) its usual residence, permanent address, registered seat, or a branch in that Member State in respect of transactions carried out by that branch.[25]

A financial institution will also be deemed to be established in a Member State if it is a party, whether acting as principal or as agent, to a financial transaction with another financial institution established in that Member State, or is a party to a financial transaction with a counterparty established in that Member State which is not a financial institution[26]. The practical impact of this condition is to widen significantly the residence and location tests of "establishment". Accordingly, a US bank (being a financial institution) entering into a financial transaction with an EU incorporated company (a non-financial institution) would fall within the charge to FTT as regards that financial transaction. This would be the case even if the financial transaction is entered into by the US bank from New York. The US bank would be liable for any FTT due, with the EU corporate counterparty being jointly and severally liable.

One interesting provision in the Directive in this particular regard is that a financial institution will not be treated as being established in a Member State where the person liable to pay FTT is able to show that there is "no link" between the economic substance of the transaction and the territory of any Member State. The term "economic substance" is not defined, and it will be interesting to see how and to what extent this provision is amplified or addressed in guidance.[27] Perhaps equally important is the requirement that relief is available only where "no link" exists

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[24] Directive, Article 1.4. See also the examples section of this memorandum below.

[25] The rule for determining the presence of an "establishment" has an order of priority, which is relevant in the context of the question of where tax is borne (see Directive, Article 3.1 to 3.2).

[26] Directive, Article 3.1.

[27] Directive, Article 3.3.

with the economic substance of the transaction. In circumstances where "economic substance" is evaluated by reference to a blend of factors (some of which may be subjective), the absolute prohibition on any link to that economic substance existing is likely to be a demanding test to satisfy.

As a result of the broad territorial scope of FTT, non-EU financial institutions with no European presence whatsoever could fall within the ambit of FTT simply because their counterparty is itself established in a Member State. A US bank entering into a derivative under market standard documentation from its New York head office with a bank in the UK would therefore be treated as being "established" in the UK for FTT purposes. The US bank would be liable to pay FTT, with the UK bank being jointly liable. It is submitted that the extra-territorial scope of the definition of "establishment" is intentional, and is intended by the EU Commission to act as a deterrent to the migration of financial transactions to non-EU based financial institutions. However, the impact of such a deterrent may be quite limited. The wide territoriality of FTT may prompt non-EU banking groups to incorporate treasury companies outside the EU with which non-EU bank branches or bank group companies can then do business, with the result being avoidance of FTT.[28]

Rates and collection

FTT will be charged at two rates. While Member States will be able to set their own rate, a minimum rate is proposed to be set at a level which achieves the "harmonization objective"[29] of the Directive while minimizing the risk of delocalization. The minimum rate of FTT has been set deliberately low to attempt to avoid a negative impact on financial markets. Accordingly, a minimum rate of 0.1 per cent. is the rate of FTT generally charged on the purchase price or other consideration for a financial transaction. In the event that consideration is lower than market price or is the consideration for intra-group transactions, the taxable amount is to be the market price determined at arm's length at the date of the FTT charge.

A lower minimum rate is to be imposed for derivatives at 0.01 per cent. of the notional amount at the time the derivative is purchased, sold, transferred, concluded or modified. The explanation for this from the EU Commission is that "[t]his approach would allow for a straightforward and easy application of FTT on derivative agreements"[30]. However, it is worth noting that, unlike the price of physical bond, the notional of a swap does not change hands and whilst relevant, is not the only factor determining the cash flows associated with such swap.

The time at which FTT is required to be paid to a tax authority of a Member State will depend on the nature of the financial transaction. First, where a transaction is carried out electronically,

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[28] Structuring of this nature would, of course, need to take account of other tax requirements and legislation such as the UK's controlled foreign company rules.

[29] Explanatory Memorandum.

[30] Explanatory Memorandum, paragraph 3.3.2.

such as through a clearing system or on an exchange, FTT is payable "at the moment when the financial transaction occurs"[31]. Clarity will be required as to the date, or time, a transaction "occurs". The most plausible explanation for the term is that occurrence takes place when a clearing system accepts a transaction for clearing. Second, where transactions do not occur electronically, the tax is payable within three working days from the time the tax becomes chargeable.[32] Provisions are also included in the Directive for the filing of monthly returns setting out information relating to FTT during monthly periods. The Directive includes provisions under which the FTT will be included in the network of EU directives focusing on administrative cooperation and mutual assistance in the field of taxation. The Directive also requires that Member States prevent "avoidance, evasion and abuse" of the FTT regime, such as artificial division (and resultant reduction) of a derivative's notional amount.

FTT is payable by each financial institution which is a party to a financial transaction, regardless of whether that financial institution acts as agent or principal.[33] Where a financial institution acts in the name of or for the account of another financial institution in the transaction, only that second financial institution is liable for the FTT. Where a financial institution transacts with a non-financial institution counterparty established in a Member State, the non-financial institution will be jointly and severally liable for the FTT.[34] Member States can also provide that other persons may also be made jointly and severally liable for payment of FTT in addition to the persons identified as being liable in the Directive.

Owing to the priority in the Directive of determining the location of the establishment of a financial institution[35], FTT payable in respect of a financial transaction entered into by a bank branch in the EU will be paid to the Member State in which the bank's head office is authorised or incorporated. In the event that the branch funds the head office's liability to FTT and claims a corporate tax deduction for that payment, the overall result might be both a reduction of corporation tax revenues for the branch's Member State coupled with the FTT being collected by the tax authority of the Member State in which the bank head office is established. Such a scenario could cause a material adverse impact on revenues of some Member States such as the UK.

In circumstances where multiple parties are participating in a transaction, multiple FTT liabilities may arise. For example, where a financial institution acts as agent for a non-financial institution, both could be liable to FTT. Furthermore, transactions are individually subject to FTT. Where a single financial deal includes multiple, smaller, component transactions, each component

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[31] Directive, Article 4.1.

[32] Directive, Article 10.4(6).

[33] Directive, Article 9.1.

[34] Directive, Article 9.3.

[35] Directive, Article 3.1.

transaction may be charged with FTT. This cascading effect is imposed even where the multiple transactions are entered into between group members and appears to be intentional.

Another example of potential situation where multiple FTT liabilities may have to be considered is a clearing set-up, where one single derivative transaction will result through: (1) one buy-side firm (2) being authorised by its clearing broker (3) to agree the terms of a give up trade with an executing broker (to be "given up" for clearing) and the other leg of the transaction involves a (4) second buy-side firm, with its own (5) clearing broker and (6) executing broker, where a number of "original", "give-up" and "offsetting" transactions will be deemed to exist for such chain of instruction to produce one cleared transaction.

Implementation

The proposal is for the FTT to be enabled by legislation in each of the Member States by the end of 2013, with the tax taking effect from 1 January 2014.

The introduction of FTT is being proposed under Article 113 of the EU Treaty. As such, the Directive would need to be unanimously approved by each of the Member States. In the event of any Member State vetoing the Directive, as a number of commentators have contemplated that the UK Government may do, the proposals can progress under an enhanced co-operation procedure under which one or more Member States may be authorized to exercise EU non-exclusive competencies through various EU institutions with a view to protecting EU interests and propelling EU integration. It appears that any attempt by Member States to unilaterally introduce the proposals for an FFT are unlikely to succeed for a number of reasons. Legally, such a unilateral adoption would be questionable owing to the provision in Article 401 of the EU VAT Directive[36] which prohibits Member States from maintaining or introducing "turnover taxes". The question of whether the FTT would constitute a "turnover tax" in the context of Article 401 depends on a number of factors, not least whether the FTT would have the effect of jeopardising the function of the common system of value added tax by being levied on the movement of goods and services and on commercial transactions in a way comparable to VAT.[37] The question is not free from all doubt, and Member States would be wary of any unilateral introduction of an FTT in a manner which might precipitate subsequent legal challenges. Moreover, the EU Commission has identified that unilateral introduction by Member States is likely to be ineffective, citing the example of Sweden's unsuccessful bond transaction tax in 1984 to 1991 period. More generally, any unilateral introduction by a Member State of any tax which may be construed as a "turnover tax" (such as the FTT) would raise concerns within the EU as regards whether such an introduction may be contrary to the fundamental freedoms relating to free movement of capital.

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[36] EU VAT Directive 2006/112/EC.

[37] *KöGÁZ rt and others v Zala Megyei Közigazgatási Hivatel Vezetoje; OTP Garancia Biztosító rt v Vas Megvei Közigazgatási Hivatal* (Joined cases C-283/06 and C-312/06); *Rousseau Wilmot SA v Caisse de Compensation de l'Organisation autonome nationale de l'industrie et du commerce (Organic)* (Case 295/84) [1985] ECR 3759, ECJ.

The introduction of the FTT would be matched by the withdrawal of other taxes on financial transactions across the EU. Although VAT and insurance premium tax would not be affected, existing taxes such as stamp duties and stamp taxation on securities would almost certainly need to be repealed. This would be welcomed by individual investors and certain funds which currently pay UK stamp duties or stamp taxation on the purchase of UK shares at a rate of 0.5 per cent. of the purchase consideration. Purchasers of UK shares and any securities which are subject to UK stamp taxes which are established outside the EU but which transact with non-EU persons outside the scope of FTT would be able to avoid both FTT and UK stamp taxation. However, these residual benefits have to be set against the prospect of some Member States losing significant stamp taxation revenue[38].

Problems, Uncertainties and Policy Objectives

Revenue Raising?

The provenance of the FTT is readily apparent as being a tax arising from the financial crisis which is aimed at both disincentivising transactions which are perceived to pose a risk to market stability and also eliciting a degree of reparation from the European financial sector. The revenue estimates for the FTT are significant, being predicted as being in the region of €57 billion per year shared between the Member States[39]. The EU Commission Impact Assessment accepts that "the revenue estimates for the variants of FTT heavily depend on the assumption on volume decrease and on the elasticity of remaining trade volumes to the tax".[40] Unusually for a tax, the effectiveness of the tax in raising revenue is also accepted as resulting in a "small, but non-trivial" drag on the GDP of the Member States. This is estimated as constituting a reduction in economic output of 1.76 per cent.[41], which is seen as a necessary corollary of "correcting undesirable market behaviour and thereby stabilizing financial markets"[42].

However, at a time when growth in many countries in the Eurozone is exceptionally low, it is not unduly pessimistic to suggest that introducing the FTT, with the macroeconomic impacts suggested, may push a number of EU economies towards recession. Moreover, estimates of revenue raised by the FTT appear to be predicated on an absence of widespread relocation of financial transactions to non-EU jurisdictions (a point considered further below) and are highly dependent on the plausibility of the EU Commission's underlying assumptions as regards avoidance and relocation. The negative impact of the FTT, through an increase in the cost of capital as financial institutions attempt to pass FTT costs to clients, is unlikely to be welcome at

[38] The yield from UK stamp duty and stamp duty reserve tax in 2009/2010 was calculated at GBP £2 billion.

[39] See Impact Assessment, paragraph 7.8. Estimates of the revenue raised through the FTT ranges between €16.4 billion (a 0.01% rate and assumption of high volume decrease) and €433.9 billion (with a rate of 0.1% and an assumption of low volume decrease).

[40] See Impact Assessment, paragraph 7.8.

[41] See Impact Assessment, paragraph 7.8..

[42] See Impact Assessment, paragraph 6.3.

a time when the European financial system is focused on liquidity provision, sustainable economic growth and bank recapitalization.

An argument may also be advanced that, to the extent that derivatives are often used for hedging purposes and therefore to mitigate risk, the FTT "penalises" risk reduction instruments that aim to hedge market risk such as FX risk, interest rate risk or credit risk. By disincentivising such hedging instruments, there is a danger that the imposition of the FTT engenders, and does not reduce, systemic market risks.

A "Pragmatic First Step"?

Allied to discussion regarding the macro-economic impact of the FTT is a deep concern regarding the delocalization effects of the introduction of the tax. As noted by the EU Commission itself "[t]here are strong economic reasons for a high degree of harmonization and coordination in order to avoid substitution and loopholes".[43] Furthermore, the Impact Assessment accepts that modern financial transactions are extremely mobile, citing the Swedish financial transactions tax enacted in various forms between 1984 and 1991 as an example of the danger of unilateral introduction.[44] Curiously, however, the proposal for an FTT does not take account of the possible relocation of financial transactions away from the EU. While it is clear that the EU Commission views the FTT as a key component in a global-level financial transaction tax and notes how the proposal for the FTT "demonstrates how an effective FTT can be designed and implemented" and "paves the way towards a coordinated approach with the most relevant international partners"[45], high hopes and hard realities may prove difficult to reconcile. It is telling that the focus of the EU Commission's proposals appear to be the G-20 group of countries, at least in the first instance.[46] However, given the global integrated market place, it can be strongly argued that unless *all* key financial jurisdictions (including tax shelters, tax havens and low tax jurisdictions such as Singapore) are included in an FTT, the risk of delocalization may be insurmountable. Although the Impact Assessment accepts that introduction of FTT would come with the risk of "relocation or disappearance" of some transactions (such as high-frequency derivative transactions), the policy objectives behind FTT are unlikely to be achieved if the result of FTT introduction is a wider, systemic dislocation in European financial trading and banking markets.

Indeed, at this point it is instructive to re-examine the desirability of a global FTT first expounded by Barry Eichengreen, James Tobin and Charles Wyplosz in their paper "*Two cases for sand in*

[43] See Impact Assessment, paragraph 7.7.

[44] The Swedish tax on equity securities, fixed income securities and financial derivatives, imposed between 1984 and 1991, led to disappointing tax revenues, a fall in Swedish share prices and a very significant fall in market trading. During the first week of the tax, the volume of bond trading in Sweden fell by 85 per cent. During the period of the tax, the volume of futures trading fell by 98 per cent. and the Swedish options trading market disappeared. ("Transaction Taxes and the Behaviour of the Swedish Stock Market", S. Umlauf, *Journal of Financial Economics 33*, pp 227-240).

[45] Explanatory Memorandum, paragraph 1.4.

[46] See the Explanatory Memorandum, paragraph 1.4, and note the focus on the "*most relevant international partners*", an expression at least suggestive of the proposal being discussed at the G-20 summit meeting in November 2011.

the wheels of international finance" (the "**Tobin Paper**")[47]. In the Tobin Paper, the authors identified two situations in which an FTT might be beneficial. The first FTT was intended to be an additional lever in the monetary machine of national governments. In the pre-1971 Bretton-Woods world of exchange rate pegs, exchange controls had been used as a defence by monetary authorities in defending their pegs from speculative "attack". As countries abandoned their pegs, exchange controls were no longer needed and currencies floated freely against one another. The proposition of Tobin and his co-authors was that relinquishing control of exchange rates also meant relinquishing control over domestic interest rates and that domestic interest rates would therefore be vulnerable to short term volatility in exchange rates. Since exchange controls are not compatible with a free-floating currency, and short term exchange rate volatility was perceived to be undesirable, an FTT was thought to be a way of reducing damaging short term exchange rate volatility.

At first glance, it appears difficult to reconcile the underlying intention of the FTT as proposed by the EU Commission with the original aims of Tobin *et al*. Tobin and his co-authors proposed a global FTT that was aimed solely at foreign exchange transactions. The EU FTT would be neither global nor would it be targeted at foreign exchange transactions (which are outside the scope of the FTT).

However, the second case for "sand in the wheels of international finance" which the Tobin Paper identified, concerned Stage II of the Maastricht Process leading up to European monetary union. A tax analogous to what has now been proposed as the FTT was presented as a means by which the risk of a breach of the EMU convergence criteria, resulting from a speculative "attack" on a currency, could be reduced. Rather than taking effect directly as a tax on forex transactions (which could not be enforced outside the EU), their version of the FTT was to be applied to loans to non-residents by individual Member States. This would have had the effect of indirectly increasing the cost of trading the ERM currencies and, it was thought, deterring short term "speculators". As the authors recognised, however, this would have required a curtailment of the EU Treaty freedoms as it would clearly have discriminated between domestic borrowers and borrowers in other Members States.

There are two lessons that might be drawn, however, from the second case given in the Tobin Paper in attempting to unpick the motives of EU Commission policymakers in 2011. Firstly, the FTT can be used as a tool for protecting an exchange rate peg. This puts the focus clearly on the Eurozone countries in the current context as opposed to the wider EU. Secondly, since the former ERM countries no longer have currencies that can be traded, an FTT on forex would be inapplicable[48] but an FTT on other forms of financial instrument used to exploit arbitrage between Eurozone Member States might be of great interest. One of the recurring themes of the European financial crisis has been the volatility of interest spreads of the sovereign debt of

[47] "Two cases for sand in the wheels of international finance", *The Economic Journal*, Vol 105, Issue 428 (Jan 1995), 162-172.

[48] Which may explain why forex transactions are outside the scope of the FTT.

peripheral Eurozone countries over Germany's sovereign debt. It might therefore be expected that short-term "round-trip" transactions relating to the sovereign debt of Eurozone countries[49] are the real focus of the EU Commission and that that, correspondingly, the FTT *should* be of far more limited relevance to the UK and other non-Eurozone countries. As the UK's financial sector will be acutely aware, however, this reasoning has not been reflected in the drafting of the Directive, which extends to all Member States and not merely the Eurozone countries. Correcting this mis-alignment may well be a priority for lobbyists on behalf of the UK financial sector and, possibly, the UK Government.

This sheds some light on the much-publicised tension between the UK and Eurozone in respect of the Directive. The main economic benefit of an FTT identified by Tobin *et al* is likely to accrue to the Eurozone members. If the scope is widened, the Tobin Paper indicates that there might be some economic benefit in doing this on a global scale but not otherwise (as markets will move elsewhere). The UK could find itself suffering the worst of both worlds, losing a proportion of its international markets in financial instruments as a result of the FTT and receiving no appreciable increase in control over its own monetary policy (when compared to the Eurozone members).

Avoidance and Counter-Avoidance

Just as there remain a number of uncertainties over the scope of financial instruments that are subject to FTT, it is also unclear at the current time how attempts to restructure financial instruments to fall outside FTT may be counteracted. The Directive provides expressly for the Member States to adopt measures to "prevent tax evasion, avoidance and abuse"[50], and it is submitted that much focus will be placed upon the apparent exemption for loan finance, insurance contracts and mortgage lending.

Deconstructing a floating rate loan with a derivative hedge into a fixed rate loan or sequence of fixed rate loans would appear to avoid FTT to the extent that loans are not themselves "financial instruments". Other more sophisticated financial engineering may be possible. Notional amounts of derivatives could be reduced, with a corresponding increase in the quantum of payments under that derivative. Derivatives could also be restructured as cross options, or contracts of insurance, indemnity or guarantee. Other instruments may have their market value reduced through the addition of commercial conditions or restrictions. How planning devices of this nature, long seen in direct tax structures and generally combated through anti-avoidance measures and jurisprudence, would be addressed is uncertain.

Structuring transactions around the boundaries of a tax charge is nothing new. However, the importance in the FTT regime of transactions and instruments may be viewed as giving the FTT an inherent vulnerability which might be seen as being out of step with some other forms of

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[49] Including derivatives written over, and repos and stock loans of, such debt and of the debt of state-backed institutions.

[50] Directive, Article 11.1.

taxation (such as service and supply-based taxes)[51]. Combating avoidance in this area is unlikely to be straightforward, particularly if the abuse of rights doctrine formulated in the line of cases leading to *Halifax*[52] is to be deployed. In transactions where lending relationships or insurance contracts[53] are entered into by participants instead of derivatives, it may well be difficult to identify abuse in a *Halifax* context owing to the likelihood that the financial activity entered into has some explanation other than the mere attainment of tax advantages.

Territorial Restructuring

In addition to market participants scrutinising the form of their transactions with a view to considering whether careful structuring may avoid the imposition of FTT, the territoriality of FTT may also propel market participants towards restructuring their activities on an entity by entity basis. For a non-EU financial institution, FTT could be mitigated through derivative contracts being effected outside the EU with non-EU counterparties. For EU financial institutions, treasury subsidiaries and SPVs could be established in non-EU territories to prevent the contracting financial institution being subject to tax. Additional analysis will be needed before such planning could be implemented, such as considering carefully the double tax treaty network of the jurisdiction in which the treasury subsidiary or SPV could be located. It is also possible that questions of beneficial ownership of income may be resurrected if such planning becomes widespread, perhaps following the line of arguments advanced in cases such as *Indofood*[54] and *Prévost Car*[55].

Reducing "overly risky transactions and activities"

One of the anticipated benefits of the FTT is that the tax will "set incentives to reduce overly risky transactions and activities".[56] The EU Commission has anticipated that the FTT could "curb speculation, noise trading and technical trade, and ... decrease markets' volatility".[57] While it is possible that automated high-frequency trading which is undertaken by EU entities and from EU permanent establishments may be driven out of the EU if the FTT in its current form was to be introduced, any reduction in systemic market and financial risk may be outweighed by other negative, behavioural consequences resulting from FTT.

For example, the definition of "financial transaction" would result in transfers of collateral falling within the scope of FTT, and being charged separately on each transfer at the higher rate of 0.1

[51] Interesting comparisons might also be drawn with measures used by the UK Government to counteract and combat stamp taxation planning schemes prior to the introduction of stamp duty land tax in 2003.

[52] *Halifax plc v Customs and Excise Commissioners* [2006] STC 919, ECJ Case C-255/02

[53] The incidence of insurance premium tax would need to be lower, if not mitigated entirely, than the potential FTT for the transaction in question before such a restructuring was worthwhile.

[54] *Indofood International Finance* Limited *v JPMorgan Chase Bank NA London Branch* [2006] EWCA Civ 158

[55] *Prévost Car Inc. v The Queen (*2008 TCC 231).

[56] Algirdas Šemeta, EU Commissioner for Taxation and Customs Union, Audit and Anti-Fraud, speaking at the FEE Tax Day 2011 Brussels, 11 October 2011: "*EU tax policy in support of the EU 2020 Growth Strategy*".

[57] Impact Assessment, paragraph 7.8 "*Risk-taking and behavioural* effects".

per cent. applicable to securities. Consequently, and coupled with the exemption of lending transactions from the scope of FTT, the imposition of FTT on posting and transferring collateral may lead to fewer collateralised lending transactions in the form of repos and stock loans and an increase in uncollateralised lending. Such a development is unlikely to add materially to fiscal stability or creditor protection. Derivatives are marked-to-market on a daily basis and as a result, collateral in respect of such daily exposure may get transferred daily during the life of the swap: it is to be hoped that such daily collateral transfers will be excluded from the scope of the FTT.

The possible incentives for financial institutions to undertake financial transactions outside the EU, in consequence of the territorial scope of FTT, also appear likely to encourage financing away from regulated, highly capitalised European financial institutions and markets towards less regulated, more thinly capitalised offshore financial centres to which derivative broker/dealers and other market participants may have migrated. Combating such migration will be difficult; it would be unrealistic to anticipate that the main offshore financial centres would willingly impose an FTT, at least not in the short term.[58] Furthermore, it is difficult to discern a regulatory and policy approach within the FTT which is contiguous with other EU regulatory initiatives. For example, whereas regulatory initiatives such as the EU Solvency II Directive include extensive measures to determine whether non-EU insurer solvency regimes demonstrate sufficient equivalence to European regulatory requirements, the FTT may result in financial activities being transferred to less-intensively regulated offshore jurisdictions where such equivalence may not yet have been established.

A risk therefore exists that the imposition of the FTT might lead to a greater number of uncollateralised and thinly regulated transactions. Such a result is exactly the opposite of the policy objectives articulated by the EU Commission.

The Bonfire of the Exemptions

Another notable feature of the FTT regime is the lack of exemptions in areas where they might commonly be found in a UK taxation context. In some instances this may be explained by reference to the principles identified in the Tobin Paper and which underlie the FTT (see above), but this is not the case in all situations. For example:

- The lack of an intra-group exemption: It is hard to envisage a situation where group companies could realise an overall "speculative" profit from round-tripping EU financial instruments or entering into intra-group derivative contracts that are fully hedged by external ones. If all the parties are both within the group and within EU territorial boundaries, all profits on the round-trip transaction might be expected to be exactly offset by an equal

[58] It is tempting to contemplate that a G-20 adoption of a financial transaction tax along the lines of the FTT could lead to a global adoption of that tax, including by offshore financial centres. However, such a unified adoption of a global tax would be a lengthy process. The precedents for such a measure are unappealing; global measures to combat climate change have been notoriously difficult to achieve as the UN Climate Change Conference in Copenhagen in December 2009 demonstrated.

amount of losses. Of course, the expectation may be that the profits will arise in lower tax EU jurisdictions and losses may arise in jurisdictions where they can be used to most effect.

- There is no exemption for intermediaries: This could be interpreted as a symptom of a tax which is targeted at all levels of the market and not just the ultimate investor (in contrast to the regime of SDRT and stamp duty exemptions for intermediaries).
- There is no exemption for repos or stock lending: Given that stock loans are often the vehicle by which stocks and bonds are "shorted" it may not be surprising that there is no FTT exemption for stock lending. It is less easy to understand the lack of an exemption for repos (and indeed other collateral arrangements) where the purpose of the transfer of the financial instrument is an ancillary purpose of the main transaction. Indeed, repos are often accounted for as secured loans and, in the US, are characterised as such for tax purposes.[59] A mortgage or charge of a financial instrument between members of the same group would also appear to be caught under Article 2.1(1)(b) of the Directive, although it will be difficult in such circumstances to identify any taxable consideration for such a transaction.
- There is no exemption for loan capital: As mentioned above, while it appears that lending and borrowing by households, private enterprises and financial institutions are not intended to fall within the scope of the FTT, there is no express exemption. Debts which are "transferable securities" are subject to the FTT as they will be financial instruments. This is likely to increase the cost of debt finance at a time when the EU as a whole can hardly afford to do so. However, there may be some perceived benefit in disincentivising speculation in bonds issued by Eurozone sovereigns, state backed institutions and other large corporates.
- Unlike the proposed EU directive dealing with central clearing (EMIR), there is no exemption from FTT for transactions of corporate entities done for the purposes of hedging.

Introduction through the VAT system

The suggestion has been raised in some corners, and notably by the Conservative MEP Kay Swinburne, that the EU Commission is looking at ways in which an FTT might be introduced within the current EU VAT regime.[60] The purported attraction for the EU Commission is that this would enable the objections of the minority to the Directive, especially the UK, to be circumvented through qualified majority voting. However, such an approach would present considerable difficulties. It should also be said that while this is an interesting idea, a VAT-based FTT is likely to prove a misplaced concern due to the unlikelihood that such an approach would achieve all, if any, of the FTT's goals. Assuming that FTT would not be regarded as a turnover tax,[61] the result of removing transactions in financial instruments from the scope of the VAT exemption could result in a number of perverse consequences. For example:

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[59] *Nebraska Department of Revenue v Lowenstein*, 513 U.S. 123 (1994).

[60] See, for example: "MEPs plot way to get tax past UK's veto", *The Daily Telegraph*, 4 October 2011.

[61] Which is prohibited by Article 401 of the VAT Directive (2006/112/EC).

- The abolition or the narrowing of the finance exemption will result in greater recovery of unattributable input tax for partially exempt entities and full recovery of input tax attributable to the newly taxable transactions. It is, of course, a misconception to regard the finance exemption as an exemption for financial institutions. It is rather an exemption for consumers which is, effectively, paid for by financial institutions who in turn may pass that cost to consumers through higher fees. Removing the exemption would clearly not achieve the EU Commission's aim of seeking a fair contribution from financial institutions in this respect.
- Notwithstanding the point above, the initiative might raise no extra VAT at all if private consumption remains exempt. Since VAT is a tax which falls ultimately on the consumer, extra tax would only be forthcoming where consumers paid irrecoverable VAT on their finance costs. The prospect of voters paying VAT on their mortgages across the EU is unlikely to be appealing on a national level. If the principle that private individuals should be excluded from the scope of FTT is extended to an analogous VAT amendment, either the exemption would have to remain in place for transactions with non-taxable persons or those transactions could be zero-rated. Since zero-rating would result in full recovery of attributable input tax, this is likely to be revenue-negative across the EU. Narrowing the scope of the exemption to consumer credit transactions, might be revenue positive; but only where value is actually being added in the chain of credit transactions which are removed from the scope of the exemption. Broadly, the effect of such a move would be to subject a proportion of the financial institution's profits to VAT. However, it should also be remembered that this might result in large VAT rebates for loss-making institutions, particularly those which have been rescued and recapitalised at the taxpayer's expense.
- Subjecting the value-added in finance transactions, and the consideration for the end product, to VAT would be tantamount to raising interest rates. This could have an adverse effect on the EU's economy as a whole.
- The application of VAT to financial instruments is unlikely to have any effect on the systemic stability of financial markets. While the administrative burden in relation to the issuance of invoices may increase, this in itself may not have an appreciable deterrent effect in relation to high-frequency, speculative transactions.

It therefore becomes clear, when comparing a VAT-based approach to the objectives of the EU Commission, that using the VAT system in this way is not going to present an easy solution which will deliver the desired results. There are also difficulties in measuring "value-added" in relation to financial transactions, and determining what lies outside the scope of VAT altogether, which are conveniently avoided by the current finance exemption.

Policy Asymmetries

As can be seen, there are some self-evident policy asymmetries and inconsistencies at the heart of the FTT proposals. However, there does appear to be some logic in favour of an FTT when it is viewed as "throwing sand in the wheels" of international or EU-wide finance. Examining each objective in turn:

- The FTT is meant to ensure that financial institutions make a "fair contribution" to covering the costs of the economic crisis. There are two difficulties in accepting this objective at face value. Firstly, the EU Commission itself estimates that the FTT will reduce GDP by 1.76 per cent. which, based on Eurostat's GDP figures for 2010,[62] implies a cost of $286 billion. This compares poorly with the modest estimates of what the FTT might raise and suggests that the FTT may not raise revenue once the negative impact on other tax revenues is taken into account. Secondly, FTT revenue will not contribute to covering the cost to individual member states of the economic crisis but is proposed as an addition to the EU budget.
- The FTT is designed to avoid fragmentation in the market for financial services, "bearing in mind the increasing number of uncoordinated national tax measures being put in place". It is true that the FTT would result in harmonisation, but this argument might be made in respect of any tax measure. Furthermore, while the EU is a customs union its remit is not to impose capital controls which, arguably, the FTT may be construed as achieving in substance if not in form. In addition, although members of the Eurozone have a vested interest in discouraging transactions which tend to undermine the stability of monetary union, it is difficult to see why it is any more essential that the UK, being outside the Eurozone but within the EU, should implement an FTT than, say, the US.
- The FTT is meant to "create appropriate disincentives for transactions that do not enhance the efficiency of financial markets". As already discussed above, this objective appears to have its roots in the economic theory behind the so-called "Tobin taxes". The FTT could be expected to disproportionately affect the lower-margin, high frequency transactions. It is therefore possible that this is where the real value of an FTT lies.

If the EU Commission believes firmly that an FTT would be of value in promoting the stability of the Eurozone by removing speculative elements from the market for sovereign debt obligations, it is possible that the Eurozone states will explore the potential for introducing an FTT using the enhanced co-operation procedure under Article 326 of the EU Treaty. While the enhanced cooperation must comply with the rights of Member States which do not participate, there does not appear to be any significant impediment to the Eurozone states introducing an FTT as a group (unless the FTT could be regarded as a turnover tax prohibited by Article 401 of the VAT Recast Directive 2006/112/EC).

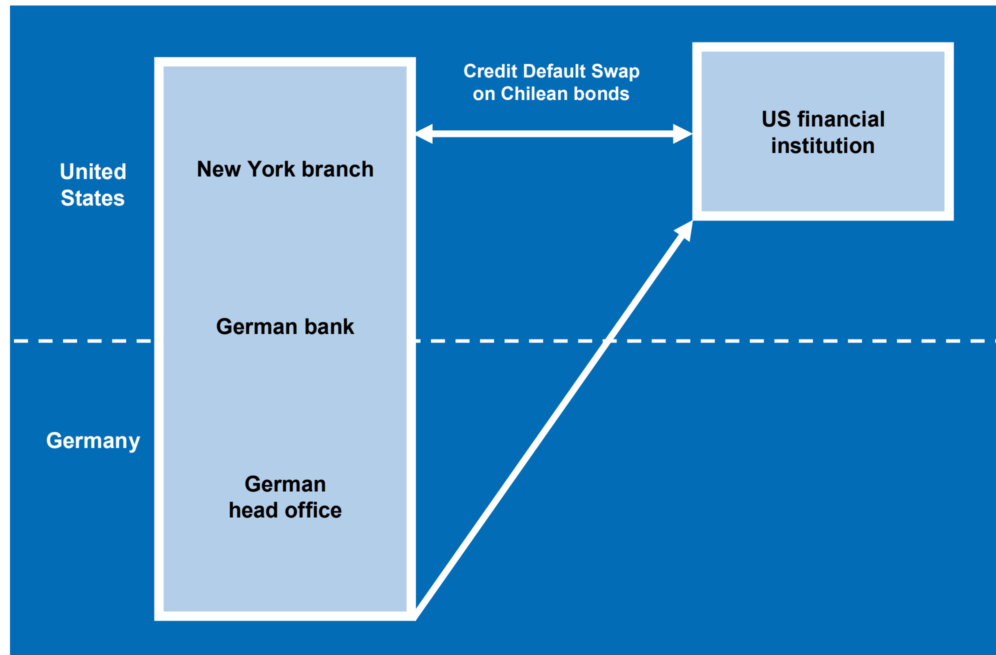
[62] $16,242,256 million in 2010 according to the IMF, see http://www.imf.org.

Application in Practice: Some Examples

In order to illustrate the transactional boundaries of FTT more clearly, some examples as to how FTT might apply to a range of financial transactions between "financial institutions" follow. As can be seen, the scheme of the Directive can lead to surprising results for transactions which may have little connection with the EU.

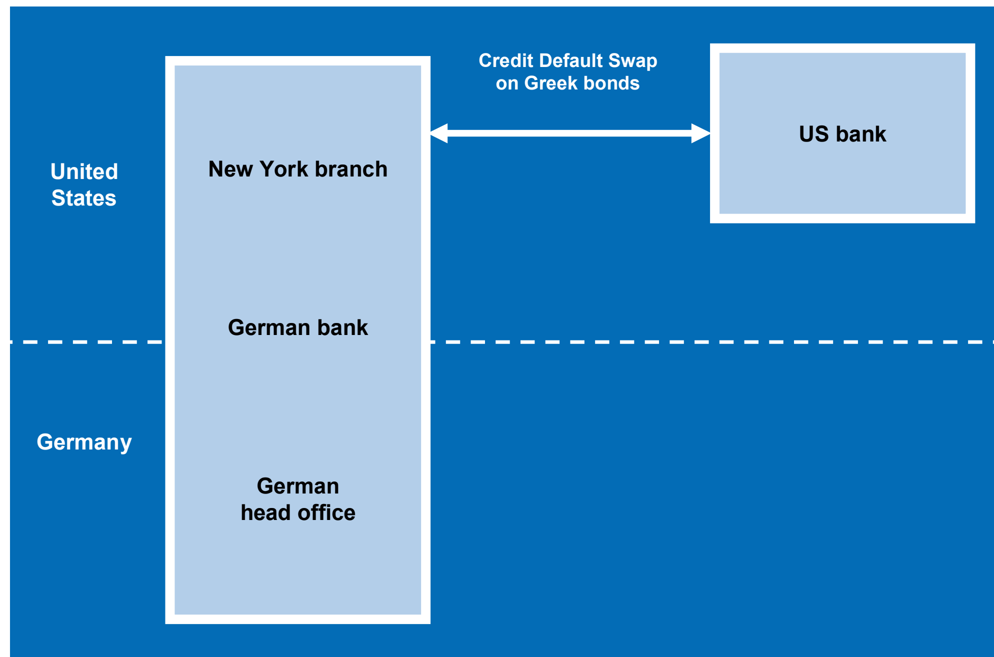
Example 1

A financial institution based in the US enters into a credit default swap with the New York branch of a German bank in respect of Chilean government bonds. FTT may not apply to the German bank under Article 3.1(b) and (c) or the US bank under Article 3.1(e) as a result of the exemption at Article 3.3 which provides an exemption from FTT where there is "no link between the economic substance of the transaction and the territory of any member state". However, any credit support arrangements relating to the swap may also need to be considered with care in the event that collateral is provided by the German bank's head office or where the collateral itself is issued by an EU issuer:



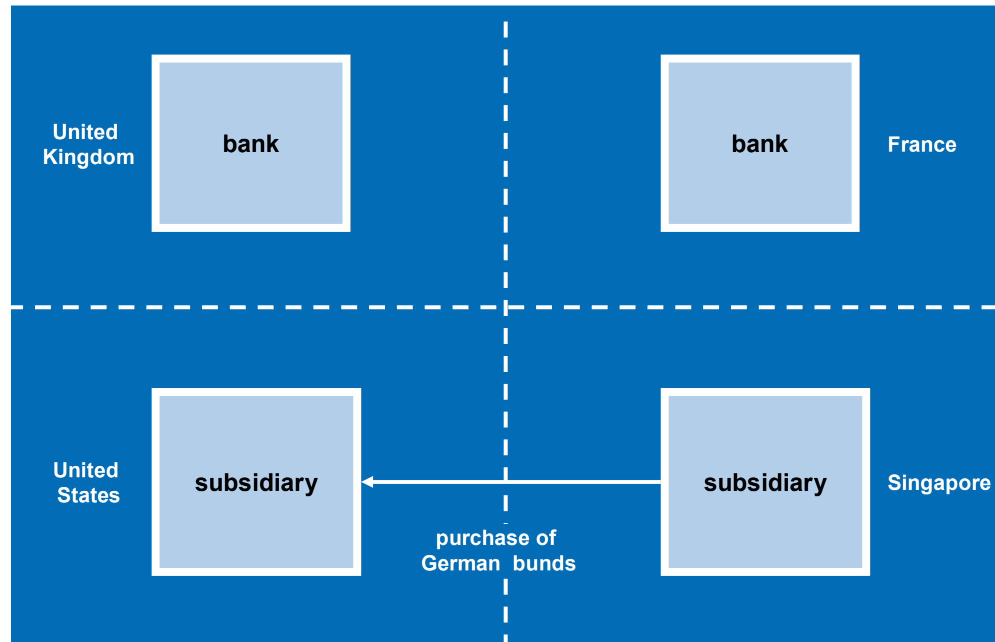
Example 2

A US bank enters into a credit default swap with the New York branch of a German bank in respect of Greek government bonds. FTT would be payable at 0.01 per cent in Germany by both the German bank under Article 3.1(b) and (c) and the US bank under Article 3.1(e) as the exemption at Article 3.3 is unlikely to apply due to the nature of the reference obligation (It is submitted that strong arguments may be made that there is no economic connection between the New York branch of the German bank, the US bank and an EU member state if the Greek government bonds are perceived as merely a variable which influences the payments under the credit default swap. However, it is also submitted that the approach of the EU commission appears to be, from a policy perspective, that such transactions should fall within the scope of the FTT):



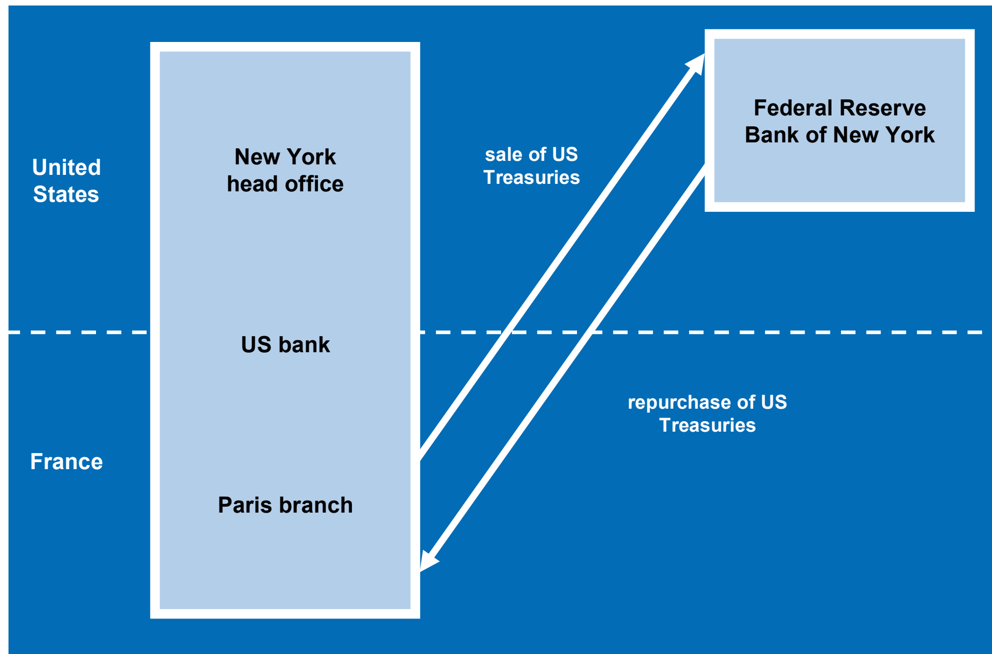
Example 3

The US subsidiary of a UK bank purchases German bunds from a Singaporean subsidiary of a French bank. No FTT should be payable as neither subsidiary (even if constituting a "financial institution") is treated as "established" in a Member State:



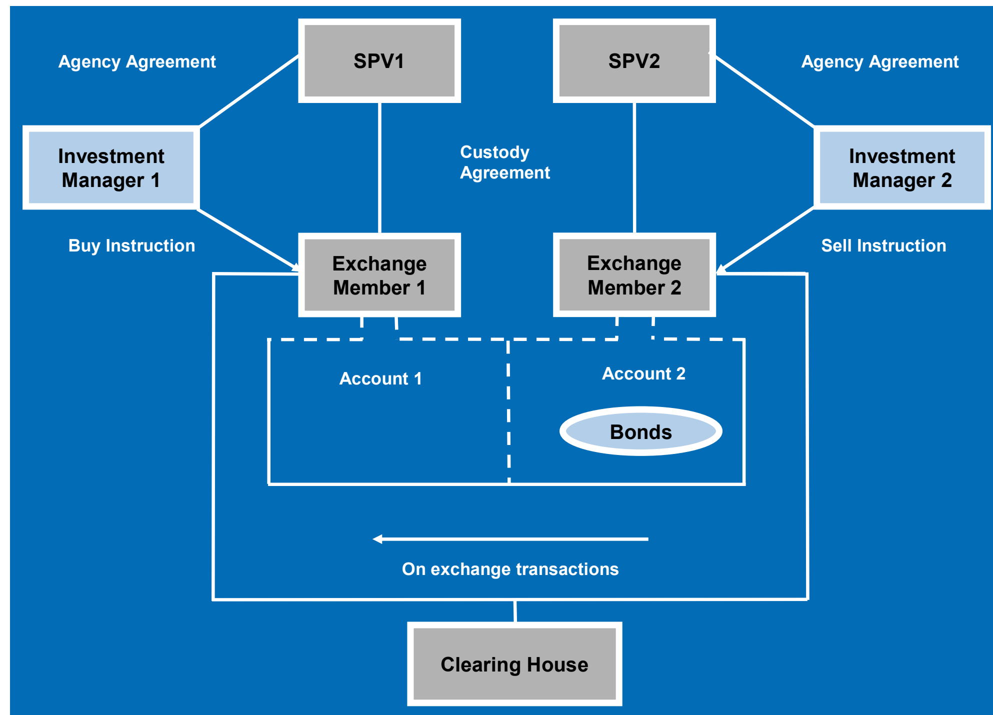
Example 4

The Paris branch of a US bank enters into a repo of US Treasuries with the Federal Reserve Bank of New York. FTT of 0.1 per cent would be payable in France on the transfer of US Treasuries on both legs of the repo by both parties:



Example 5

On the basis of the current drafting of the Directive, it would seem that the purchase and sale of a bond might be subject to six separate charges to FTT. For example, two financial institutions may each have an account with a clearing system. Two other financial institutions (SPV1 and SPV2) may, for differing reasons, wish to purchase or sell (respectively) a particular bond which is immobilised in the clearing system. The trade is effected by the account holding institutions as custodian, in each case, upon the instructions of the investment manager acting for SPV1 and SPV2. Since (i) the trade is carried out for the account of SPV1 and SPV2, in each case, (ii) the financial institutions are party to the transaction for the account of the SPVs, and (iii) the investment managers are acting in the name of the SPVs, a charge of 0.1 per cent could arise on each of the six participants in the trade:



Conclusion

The European Council discussed the Directive on both 11 October and 26 October 2011. Further discussion of the Directive was undertaken by the European Council of Finance Minsters ("ECOFIN") in Brussels on 8 November 2011. Formal discussions have also be accompanied by widely reported press statements in support of the FTT by Algirdas Šemeta, the EU Commissioner responsible for taxation and customs union, audit and anti-fraud, and by a number of leading politicians, perhaps most notably Dr. Wolfgang Schäuble, the German Minister of Finance. A variety of commentators, politicians, lobbyists and interested parties have also given their (generally adverse) views of the proposals.

Discussions also took place regarding the merits and practicalities of a global financial transaction tax at the G-20 summit in Cannes on 3-4 November 2011. However, overshadowed by the on-going crisis in the Eurozone and in particular regarding the impact of that crisis on Greece, little progress was made regarding global introduction of a financial transaction tax. Notwithstanding forceful advocacy by France, it appears that a large number of G-20 nations including the United States, Britain and Canada remained concerned during the G-20 discussions about the practicalities of introducing a tax on a global scale and (in the case of the United States) preferred to follow a different approach to seeking contributions from the financial sector for the costs of the financial crisis.[63]

Divisions have also, perhaps unsurprisingly, emerged between the Member States. In early November 2011, the UK Government publically stated that it would only endorse an international version of FTT, and would not support an EU-wide introduction alone.[64] Citing concerns over the use of revenues raised by the FTT, the UK Government's opposition to the tax appears to be matched by serious concerns in Sweden over whether the FTT is credible at a time when the focus in the European Union is on growth and attracting business.[65] Although the finance ministers of Spain, Belgium and Austria have suggested that the implementation of a financial transactions tax would be viable across the 17 members of the Eurozone, both Ireland's Finance Minister, Michael Noonan, and European Commission President, José Manuel Barroso, have distanced themselves from such a move.[66] It now seems likely that, following the ECOFIN meeting on 8 November 2011, the proposed Directive will remain in limbo pending further discussion by the EU Commission and ECOFIN in the first half of 2012.

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63 "*G20 fails to endorse financial transaction tax*" Reuters, 4 November 2011. The G20 Summit Final Communiqué, at paragraph 28, included the anodyne statement that "We acknowledge the initiatives in some of our countries to tax the financial sector for various purposes, including a financial transactions tax, inter alia to support development".

64 "*Europe confused on financial transactions tax – UK*", Reuters, 7 November 2011; "*Osborne says UK is opposed to EU financial transaction tax*", Bloomberg, 27 October 2011.

65 "*Fekter, Reynders endorse Euro-area financial transaction tax*", Business Week, 8 November 2011.

66 "*No EU deal on transaction tax – Noonan*", Irish Times 8 November 2011; "*Fekter, Reynders endorse Euro-area financial transaction tax*", Business Week, 8 November 2011.

It is possible that in any future discussions regarding the FTT in 2012, the EU Commission's position may evolve as concessions are sought from Member States and negotiating positions are refined. A similar evolution was seen in the genesis of the EU Savings Income Directive, with the original proposed directive presented by the EU Commission in March 1998 on a common system of taxation applicable to savings income being highly controversial and potentially unworkable.[67] Following intensive discussions at both political and technical levels during the period from 1998 to 2000, the approach of the EU Council to the draft directive developed, with the final version of the directive adopted on 3 June 2003[68] including a number of material differences to the 1998 draft, and being markedly more practical and workable as a result.

Many financial institutions, and one suspects some Member State governments, may be hoping that something similar happens as regards this Directive.

[67] See "*Comments on the Directive 2003/48/EC on the Taxation of Savings*", Albert J. Rädler, Casa Editrice Dott. Antonio Milani, 2005.

[68] Directive 2003/48/EC on taxation of savings income in the form of interest payments.